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B1, 1.4(B), 1.4(D)

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P 012237Z DEC 92
FM AMEMBASSY CARACAS
TO SECSTATE WASHDC PRIORITY 5872
INFO USDOC WASHDC
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USCINCSO QUARRY HEIGHTS PM
AMEMBASSY BOGOTA
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E.O. 12356: DECL: OADR
TAGS: EFIN, ETRD, PGOV, EINV, KIPR, ENRG, ECON, VE
SUBJECT: THE VENEZUELAN ECONOMY AFTER COUP ATTEMPT II

REF: (A) CARACAS 010474, (B) CARACAS 012489

1. CONFIDENTIAL - ENTIRE TEXT

2. SUMMARY: OUR EARLY CONVERSATIONS FOLLOWING THE
EVENTS OF LAST FRIDAY INDICATE THAT PRESIDENT PEREZ HAS

UNITED STATES DEPARTMENT OF STATE

REVIEW AUTHORITY: OSCAR J OLSON

CLASSIFICATION: CONFIDENTIAL REASON: 1.4(B), 1.4(D)

DECLASSIFY AFTER: 30 NOV 2017

DATE/CASE ID: 17 AUG 2006 200503206

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ONLY BEGUN TO THINK HOW HIS ADMINISTRATION MAY ATTEMPT TO CAPITALIZE ON THE PUBLIC REVULSION RAISED BY THE LATEST COUP ATTEMPT TO REVITALIZE HIS PRESIDENCY. THE STAKES GO WELL BEYOND THE PERSONAL POLITICAL SURVIVAL OF CAP. ANY RETURN TO THE POLITICAL GRIDLOCK AND PARALYSIS THAT FOLLOWED LAST FEBRUARY'S COUP MAY WELL MEAN THE ECONOMIC MEASURES NECESSARY TO CORRECT THE GROWING IMBALANCES IN THE ECONOMY, IN PARTICULAR THE PUBLIC SECTOR BUDGET DEFICIT, INFLATIONARY PRESSURES, AND THE EXTERNAL ACCOUNTS, WILL NOT BE TAKEN IN TIME TO PREVENT SERIOUS ECONOMIC PROBLEMS IN THE FUTURE. IF ANYTHING, THE BLOW TO BUSINESS CONFIDENCE CAUSED BY RECENT EVENTS WILL TEND TO EXACERBATE THESE IMBALANCES; HOWEVER, SHORT OF A COMPLETE COLLAPSE IN PUBLIC CONFIDENCE IN THE ECONOMY (UNLIKELY AT THIS POINT), THESE PROBLEMS WILL LOOK MORE LIKE A SLOW DETERIORATION IN ECONOMIC PERFORMANCE THAN A DRAMATIC CRISIS. CAP'S ATTEMPTS TO CONSOLIDATE HIS ECONOMIC REFORM PROGRAM IN HIS FINAL YEAR IN OFFICE, INCLUDING THE BILATERAL ECONOMIC AGENDA WITH THE UNITED STATES, WERE AMBITIOUS EVEN BEFORE THE

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LATEST POLITICAL DISTRACTION.

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END

SUMMARY.

A ROUGH FEW WEEKS

3. IN THE EARLY DAYS FOLLOWING THE LATEST COUP ATTEMPT, CAP MAY WELL RIDE ON A WAVE OF RELIEF THAT THE COUP ATTEMPT NOT ONLY FAILED MILITARILY BUT ALSO FAILED TO ATTRACT THE PUBLIC SUPPORT IT SOUGHT. THE FINANCIAL AND CAPITAL MARKETS, HOWEVER, WILL REACT NOT ONLY TO THE CURRENT POLITICAL UNCERTAINTIES, BUT TO THE PROSPECTS THAT THE GOVERNMENT WILL REGAIN ENOUGH POLITICAL LEGITIMACY TO EFFECTIVELY MANAGE THE ECONOMY. RECENT CALMING STATEMENTS BY THE CENTRAL BANK THAT IT WILL

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ACCOMMODATE THE MARKET'S DEMAND FOR DOLLARS AND HOPES THAT THE DEFEAT OF ANOTHER COUP WILL GALVANIZE THE COUNTRY'S POLITICIANS MAY SMOOTH REACTIONS OF THE MARKETS OVER THE SHORT RUN. AT THE SAME TIME, PARTICIPANTS IN THE MARKETS WILL BE LOOKING FOR EVIDENCE THAT THE GRIDLOCK BETWEEN THE PRESIDENT AND THE POLITICAL PARTIES OVER NEEDED ECONOMIC LEGISLATION, IN

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PARTICULAR FINANCIAL SECTOR REFORM AND THE TAX PACKAGES, HAS COME TO AN END. INITIAL SIGNS ARE NOT GOOD AS REGARDS THE CRITICAL TAX BILLS: THE GOAL OF PASSING THESE BILLS IN THE CURRENT SESSION OF CONGRESS HAS BEEN PUT OFF UNTIL THE SPECIAL SESSION IN JANUARY. ON THE OTHER HAND, THE CONGRESS DID PAS THE BUDGET AND THE CENTRAL BANK BILL LATE IN THE DECEMBER SESSION. AS THE CAPITAL AND EXCHANGE MARKETS EVALUATE THE POLITICAL DEBATE IN COMING DAYS, WE EXPECT TO SEE AT LEAST SOME SIGN OF JITTERS--AND PERHAPS A SIGNIFICANT BREECH--OVER THE NEXT SEVERAL WEEKS.

4. THE NEWS ON FOREIGN INVESTOR CONFIDENCE IS ALSO NOT LIKELY TO BE COMFORTING. LIKE THE EARLY REACTION TO THE EVENTS OF FEBRUARY 4, OUR EARLY READ ON THE MOOD OF THE FOREIGN INVESTOR COMMUNITY INDICATES THERE IS LITTLE PANIC. SOLOMAN BROTHERS REPORTS THEIR CLIENTS ARE

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E.O. 12356: DECL:OADR
 TAGS: EFIN, ETRD, PGOV, EINV, KIPR, ENRG, ECON, VE
 SUBJECT: THE VENEZUELAN ECONOMY AFTER COUP ATTEMPT II

INCLINED TO VIEW THE DEFEAT OF THE COUP ATTEMPT AS
 MODERATELY POSITIVE, AND THE PRICE ON VENEZUELAN BONDS
 IN FOREIGN MARKETS HAVE DECLINED ONLY SLIGHTLY. THIS
 HAS TO BE TAKEN IN THE CONTEXT, HOWEVER, OF SIGNIFI-
 CANTLY LOWER EXPECTATIONS OVER VENEZUELAN MEDIUM-TERM
 PROSPECTS AND GROWING RELUCTANCE TO TAKE ON VENEZUELAN
 RISK. WE EXPECT EQUITY INVESTORS WILL TAKE SOME TIME TO
 EVALUATE THE SITUATION BEFORE COMMITTING THEMSELVES TO
 LONG-TERM INVESTMENTS HERE AND MAY JOIN THE PORTFOLIO
 INVESTORS WHO HAVE ALREADY MOVED TO THE SIDELINES ON
 VENEZUELAN EXPOSURE.

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----- KEY QUESTIONS STILL TO BE FACED -----

5. WHILE THE SHORT-TERM MARKET REACTION WILL GRAB THE HEADLINES, THE INCREASED POLITICAL UNCERTAINTIES ARE LIKELY TO HAVE A NEGATIVE IMPACT ON THE GROWING IMBALANCES IN THE VENEZUELAN ECONOMY. WE HAVE ALREADY IDENTIFIED THESE POINTS OF RISK TO THE CURRENT ECONOMIC EXPANSION, THE FISCAL DEFICIT, INFLATION, AND THE EXTERNAL ACCOUNTS; BUT IT IS WORTHWHILE EXAMINING HOW THESE AREAS OF WEAKNESS MAY BE AFFECTED BY THE COUP ATTEMPT. (FOR FURTHER EXPLANATION OF THESE IMBALANCES SEE REF A.)

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6. THE FISCAL DEFICIT: THE COUP ATTEMPT SHOULD HAVE LITTLE IMPACT ON THE SIZE OF THE BUDGET DEFICIT NEXT YEAR (EXCEPT PERHAPS A REVISION UPWARD IN THE MILITARY BUDGET TO REPLACE DESTROYED EQUIPMENT), BUT THERE MAY WELL BE INCREASED RELUCTANCE BY FOREIGN AND DOMESTIC INVESTORS TO FINANCE THIS DEFICIT. EVEN BEFORE THE COUP, THE DEFICIT OF FOUR PERCENT OF GDP THIS YEAR PUT STRAINS ON THE ABILITY OF THE GOV TO OBTAIN MEDIUM-TERM FINANCING. ONLY TWO DAYS BEFORE THE COUP, THE CENTRAL BANK HAD TO STRONG ARM THE COMMERCIAL BANKS TO ACCEPT TWO-YEAR REPUBLIC OF VENEZUELA BONDS AT A REPORTED INTEREST RATE OF 46 PERCENT. UNLESS THE GOV CAN REVERSE THE CYCLE OF POLITICAL UNCERTAINTY, THE RISK IS THE GOVERNMENT WILL BE UNABLE TO PLACE MEDIUM- OR LONG-TERM DEBT INSTRUMENTS TO FINANCE NEXT YEAR'S DEFICIT AND WILL HAVE TO RELY ON SHORT-TERM ZERO COUPON BONDS. WHILE THE GOV CAN PROBABLY PLACE SHORT-TERM PAPER, THE CONTINUING NEED TO ROLL OVER THESE NOTES LEAVES THE SYSTEM VULNERABLE TO A BREECH IN THE GOVERNMENT'S ABILITY TO FINANCE THE DEFICIT AND THE FATAL TEMPTATION TO COVER THE DEFICIT THROUGH MONEY CREATION. EXTERNAL FINANCING IS BECOMING A LESS VIABLE OPTION. TERMS ARE BECOMING VERY EXPENSIVE FOR THE GOV. A SENIOR BANKER WITH A LOCAL BRANCH OF A U.S. BANK TOLD US THIS SECOND ATTEMPTED COUP COMBINED WITH POLITICAL EVENTS EARLIER IN 1992 COULD LOWER THE PRICE OF VENEZUELAN PAPER TO THAT OF JUNK BONDS.

7. THE EXTERNAL ACCOUNTS: WHILE THE BALANCE OF PAYMENTS REMAINS IN A REASONABLY SOLID POSITION THIS

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YEAR AND RESERVES REMAIN HIGH, THE STRONG GROWTH IN THE
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ECONOMY MEANS THAT EVEN UNDER THE BEST OF CIRCUMSTANCES
THE OVERALL BALANCE OF PAYMENTS SHOULD REGISTER ANOTHER
DEFICIT IN 1993. INCREASED UNCERTAINTY CAUSED BY THE
SECOND ATTEMPTED COUP, HOWEVER, LEADS TO THE RISK OF
PROMPTING SHORT-TERM CAPITAL FLIGHT, SUCH AS THAT
EXPERIENCED OVER THE FIRST AND SECOND QUARTERS OF THIS
YEAR. IN ADDITION, UNLESS POLITICAL EVENTS TAKE A TURN
FOR THE BETTER, MEDIUM- AND LONG-TERM CREDITS WILL BE
LESS AVAILABLE, FURTHER REDUCING THE INFLOWS ON THE
CAPITAL ACCOUNT. WHILE THE GOV HAS SUFFICIENT RESERVES
TO DEAL WITH MOST CONTINGENCIES, FURTHER POLITICAL
INSTABILITY COULD PROMPT MASSIVE SHORT-TERM OUTFLOWS
THAT WOULD LEAVE THE CENTRAL BANK WITH THE UNPALATABLE
CHOICE OF ALLOWING THE BOLIVAR TO CRASH TO EXTREMELY LOW
LEVELS OR USING A SIGNIFICANT PORTION OF ITS RESERVE
CUSHION TO DEFEND THE BOLIVAR. EVEN IF THIS UNLIKELY
SCENARIO DOES NOT PLAY OUT, THE CENTRAL BANK WILL BE
UNDER THE GUN TO MAINTAIN HIGH REAL INTEREST RATES TO
KEEP SHORT-TERM DEPOSITS IN THE COUNTRY.

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8. INFLATION: INCREASED PRESSURES AGAINST THE BOLIVAR AND PANIC BUYING IN RESPONSE TO THE COUP ATTEMPT SHOULD PUT SOME PRESSURE ON PRICES OVER THE COMING MONTHS. THE BOLIVAR HAS ALREADY UNDERGONE A SIGNIFICANT ADJUSTMENT IN OCTOBER, WHICH SHOULD BE REFLECTED IN THE NOVEMBER AND DECEMBER PRICE INDICES. ANY FURTHER BREECHES IN THE EXCHANGE RATE WILL FUEL INFLATIONARY EXPECTATIONS THAT ARE ALREADY BEGINNING TO BUILD.

ANOTHER ROADSIDE DISTRACTION

9. WHILE THE VENEZUELAN ECONOMY HAS ABSORBED SIMILAR SHOCKS IN THE PAST (NOTABLY THE FEBRUARY 4 COUP ATTEMPT), THE INCREASED POLITICAL UNCERTAINTIES GENERATED BY THE SECOND COUP WILL REINFORCE NEGATIVE

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TRENDS THAT ALREADY EXIST IN THE ECONOMY. EVEN BEFORE THE LATEST COUP ATTEMPT, WE EXPECTED THAT, WITHOUT PROMPT ACTION ON THE PART OF THE EXECUTIVE AND CONGRESS ON ECONOMIC LEGISLATION, ECONOMIC PERFORMANCE WOULD SLOWLY DETERIORATE NEXT YEAR, WITH HIGHER INFLATION AND LOWER GROWTH. THIS IS STILL THE MOST LIKELY OUTCOME IF THE ADMINISTRATION IS UNABLE TO DEVELOP A NEW CONSENSUS TO PASS THE ECONOMIC LEGISLATIVE PROGRAM. THE COUP, HOWEVER, HAS CHANGED THE SITUATION IN SOME WAYS. THE ECONOMY MAY NOW BE MORE VULNERABLE TO A SUDDEN LACK OF

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CONFIDENCE WHICH COULD TRIGGER EVENTS THAT WOULD THROW THE ECONOMY INTO CRISIS. WHILE WE WOULD NOT BET ON THE POSSIBILITIES, ANY FURTHER POLITICAL DETERIORATION COULD CAUSE UNCONTROLLABLE CAPITAL FLIGHT, A GOVERNMENT FINANCING CRISIS, OR THE FAILURE OF FIVE OR SIX WEAK BANKS. OF COURSE, THE GOV AND SOME AD PARTY LEADERS ARE CURRENTLY HIGHLIGHTING THE OPPOSITE POSSIBILITY: THAT THE COUP PLOTTERS HAVE BEEN BEATEN FOR GOOD, AND POLITICAL STABILITY WILL RISE RATHER THAN FALL. IF THEY ARE RIGHT, WE SHOULD SEE INDICATIONS IN THE DECEMBER 6 STATE AND LOCAL ELECTIONS. IN SHORT, THE ECONOMIC OUTLOOK HAS NOT CHANGED SIGNIFICANTLY, BUT UNCERTAINTY HAS RISEN AND THE DOWNSIDE RISKS ARE MUCH HIGHER THAN BEFORE.

10. THE DISTRACTIONS OF THE LATEST COUP ATTEMPT WILL ALSO MAKE IT MORE DIFFICULT FOR CAP TO COMPLETE THE STEPS NECESSARY TO CONSOLIDATE HIS ECONOMIC REFORMS. IF THE CONGRESS PUTS ITS HEAD BACK INTO THE SAND AND FAILS TO PASS THE OUTSTANDING ECONOMIC LEGISLATION, THE PROGRAM WILL REMAIN VULNERABLE TO A QUICK REVERSAL THROUGH DECREE BY AN INCOMING ADMINISTRATION. HOWEVER,

[REDACTED] TOLD THE AMBASSADOR
DECEMBER 1 THAT THE TAX AND FINANCIAL SECTOR REFORM LEGISLATION WOULD BE PASSED WHEN THE CONGRESS IS CALLED INTO SPECIAL SESSION IN JANUARY. UNFORTUNATELY, WE HAVE HEARD SIMILAR PREDICTIONS REPEATEDLY IN THE PAST.

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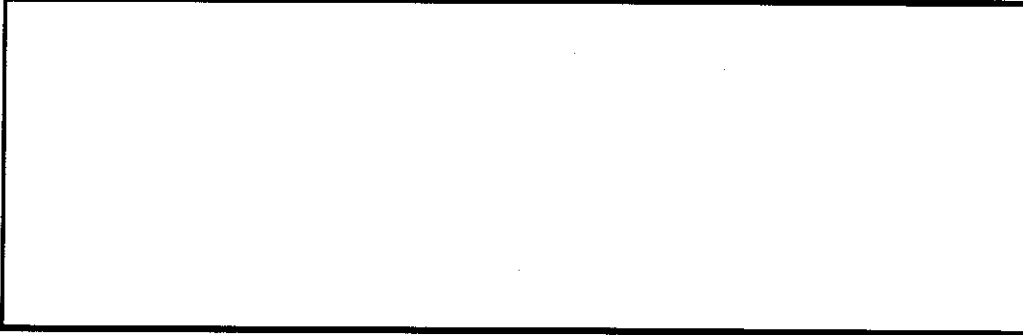
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12. WHILE THE SECOND COUP ATTEMPT PRESENTS FURTHER OBSTACLES TO CAP'S EFFORTS TO PUT THE ECONOMY ON A MORE SOUND BASIS AND TO HIS ATTEMPTS TO MAKE THE ECONOMIC REFORM PROGRAM "IRREVERSIBLE," WE DOUBT HE WILL GIVE UP ON HIS EFFORTS NOW. THE KEY QUESTION IS WHETHER THE VIOLENCE OF THE COUP ATTEMPT AND INCREASED NERVOUSNESS OF FOREIGN AND DOMESTIC INVESTORS MAKE SHAKE VENEZUELA'S POLITICAL ELITE FROM BUSINESS AS USUAL AND SET THEM TO

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WORK TO ADDRESS THE SUBSTANCE OF URGENT ECONOMIC ISSUES
OR WHETHER THEY WILL INSTEAD FALL INTO THE CONTRASTING
ERRORS OF "TRIUMPHANTISM" OR PANIC. SKOL

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